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THE "RULE OF REASON" AS APPLIED BY THE UNITED STATES SUPREME COURT TO COMMERCE IN PATENTED ARTICLES.

In the six years that have passed since the Supreme Court of the United States, in deciding the Standard Oil case, first used the term "rule of reason"¹ the Court has had occasion in five cases to consider the legality of acts which on the one hand were justified as being the lawful exercise of rights conferred by patents, and on the other hand, were asserted to be outside the monopoly created by letters patent and in restraint of trade. There are now pending in the Supreme Court four important cases, all of which have been or will be argued during this term, which present other aspects of the same subject, that is, the extent of the respective fields of operation of the patent laws and the anti-trust laws.

The cases already decided are the Mimeograph case,² the so-called "Bathtub Trust" case,³ the Sanatogen case,⁴ the so-called "Shoe Machinery Trust" criminal case⁵ and *Virtue v. Creamery Package Mfg. Co.*⁶

The last of these cases is unimportant. Of the other four cases two were Government cases under the Sherman law, of which the Government won one and lost one, and two were infringement suits brought by the patentee, in one of which the patentee prevailed and in the other was unsuccessful.

The four undecided cases now pending in the Supreme Court are the so-called "Shoe Machinery Trust" equity case,⁷ on appeal by the Government from a decision dismissing the complaint; the so-called "Motion Picture Trust" case,⁸ on appeal by the defendants from a decision in favor of the Government; the Victor Talking Machine case,⁹ on certiorari to the United States Circuit

¹Opinion of Chief Justice White, *Standard Oil Co. v. United States* (1911) 221 U. S. 1, at p. 66, 31 Sup. Ct. 502.

²*Henry v. A. B. Dick Co.* (1912) 224 U. S. 1, 32 Sup. Ct. 364.

³*Standard Sanitary Mfg. Co. v. United States* (1912) 226 U. S. 20, 33 Sup. Ct. 9.

⁴*Bauer v. O'Donnell* (1913) 229 U. S. 1, 33 Sup. Ct. 616.

⁵*United States v. Winslow* (1913) 227 U. S. 222, 33 Sup. Ct. 253.

⁶(1913) 227 U. S. 8, 33 Sup. Ct. 202.

⁷*United States v. United Shoe Machinery Co.* (D. C. 1916) 234 Fed. 127.

⁸*United States v. Motion Picture Patents Co.* (D. C. 1915) 225 Fed. 800.

⁹*Victor Talking Machine Co. v. Strauss* (2 C. C. A. 1916) 230 Fed. 449.

Court of Appeals, 2nd Circuit, which decided in favor of the patentee; *Motion Picture Patents Co. v. Universal Film Mfg. Co.*¹⁰ and others, on certiorari to the same Court as the last case, but here the decision was against the patentee.

Therefore, of the four undecided cases, two are Government cases under the Sherman act, of which the Government won one and lost one, and two are cases of infringement, in one of which the patentee was successful and in the other unsuccessful.

It is interesting to examine the varying results reached in these important cases, in four of which the Government invoked the Sherman act against the defendants who promptly sought refuge under patents and rights claimed thereunder, and in the other four of which cases the patentee asserted that his patent rights were being infringed by the defendants, who straightway answered that the rights claimed by the patentee did not exist, that they were not granted by the patent laws, and were in fact restraints of trade. It is intended in this article, in an examination of the facts and results reached to discuss the application of the "rule of reason" by the Supreme Court to the five cases which it has decided, and to consider the possible effect of those decisions in the determination of the four pending cases.

DEFINITION OF THE "RULE OF REASON."

Prior to the Standard Oil decision the term "restraint of trade" had not been authoritatively defined in this country. In that case the Court held that the term in its rudimentary meaning took its origin from the common law and was also familiar in the law of this country at the time of the adoption of the Sherman act; that the statute generically enumerates the character of acts which it prohibits and the wrong which it was intended to prevent; that protection of the public by the prevention of the monopolization of trade or commerce and by the prevention of an undue restraint on commerce is the foundation upon which the prohibition of the statute rests. The law prohibits as illegal all acts which are unreasonably restrictive of competitive conditions, or essentially obstruct the free flow of commerce between the states, or restrict the liberty of a trader to engage in interstate business.

The direct effect of the acts complained of is the criterion by which it is to be determined in every case whether there is presented a restraint of trade within the meaning of the law. Accord-

¹⁰(2 C. C. A. 1916) 231 Fed. 701.

ingly in every case we use the standard of reason for the purpose of determining whether or not an act or alleged restraint of commerce has brought about the injury from which the Sherman Anti-Trust Act is intended to guard the people. Mr. Chief Justice White said in the *Standard Oil* case,¹¹ "in every case where it is claimed that an act or acts were in violation of the statute the rule of reason, in the light of the principles of law and the public policy which the act embodies, must be applied." If the acts complained of have caused the wrongs which the statute forbade, resort to reason is not permissible to allow that to be done with the statute prohibits. It matters not what form the combination may take or what garb or dress it may put on.

The above is a simple statement of the "rule of reason". Each case must be determined on its special facts. "Reason" is invoked in order to determine whether or not the acts complained of have brought about the evils which the Sherman act was enacted to prevent. The "rule of reason" is not difficult to understand. It is the application of the rule to the particular facts presented in each case that leads to difference of opinion and heated controversy.

THE DECIDED CASES.

Seldom has a decision of the Supreme Court started as much discussion as followed the opinion of the Supreme Court in the *Mimeograph* case, sometimes called the *Dick* case, announced in March 1912. A stencil duplicating machine known as a "rotary mimeograph" was sold by the patentee subject to the license restriction that it might be used only with the stencil, paper, ink and other supplies made by the patentee. The defendant, with knowledge of the license agreement, sold to the purchaser a can of ink suitable for use upon the mimeograph, and with the expectation that it would be so used. In an action by the patentee the Supreme Court held that an action for contributory infringement lay against the vendor of the ink.

The result in the *Dick* case turned upon the question whether the restriction upon the use of a mimeograph was a "legal and reasonable condition" attached to the use of the patented article, or a restriction "inherently violative of some substantive law." Four of the justices held that it was a legal and reasonable condition. Three justices argued that the restriction under consid-

¹¹231 U. S. at p. 66.

eration was a restriction relating to the use of materials and was not such a restriction upon the use of the machine as was under the protection of the patent law.

Mr. Justice Lurton said:¹²

"Where, then, is the line between a lawful and unlawful qualification upon the use? This is a question of statutory construction."

In a vigorous dissenting opinion, Mr. Chief Justice White said:¹³

"As the right to employ any desired operative materials in using the patented machine was not a right derived from or protected by the patent law, but was a mere right arising from the ownership of property, it cannot be said that the restriction concerning the use of the materials was a restriction upon the use of the machine protected by the patent law. * * * It is a misconception to qualify the restriction as one on the use of the machine when in truth both in form and substance it was a restriction upon the use of materials capable of being employed in operating the machine."

Applying the "rule of reason" to the Dick case, it is apparent that the restriction under consideration did not tend to bring about the evils which the Sherman act was designed to prevent. The restriction left the whole world free to manufacture and sell paper and ink. It created no monopoly in unpatented things. While it reserved to the patentee the sole right to supply specified unpatented articles to specified persons, namely, to the purchasers of the mimeograph, it did not prevent others from manufacturing and distributing ink and paper to all users of paper and ink except those who had bought the patented mimeograph. The license agreement gave no one monopolistic control over the source of supply of the unpatented articles, the paper and ink, or over the demand for those articles, except in respect to the person who had bought the mimeograph. As to him only was the market curtailed and the demand controlled.

Moreover, the license agreement did not control or relate to a vast marketing or distributing system; it did not eliminate competition between jobbers or between retailers; it was an agreement to which only the patentee and the purchaser of the patented article were parties. The Court did not consider whether the license agreement would have been enforceable against a third party if the

¹²224 U. S. at p. 26.

¹³224 U. S. at pp. 52, 53.

latter had acquired the mimeograph from the vendee of the patentee for that question was not before the Court at that time, but is presented in one of the cases now pending in the Supreme Court, namely *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, and others, to be discussed later in this article.

In his dissenting opinion in the Mimeograph case, Mr. Chief Justice White said that he was led to make a statement of the reasons which constrained him to dissent because of the hope that the statement might serve "to suggest that the application in future cases of the construction now given be confined within the narrowest limits."

Eight months later in the so-called "Bathtub Trust" case, in which the Dick case was the main reliance of the defendants, the Court held in a unanimous opinion that patents and patent rights cannot be made a cover for violation of the Sherman act. This case was an instance of an attempt to conceal an agreement fixing prices and interfering with competitors under the guise of a legitimate licensing arrangement for the use of patents; the defendants incorporated many unlawful restraints in so-called "license agreements", each corporation defendant entering into one of these "license agreements" with the same contracting party to whom three patents had been transferred before the signing of the contracts. The patents related to a tool used in the manufacture of unpatented ware. The defendants urged as justification that the restraints alleged by the Government to be unlawful were proper restrictions lawfully imposed by the owner of a patent on a tool used in the manufacture of the ware, who had issued licenses under the patent to the manufacturers. The Government argued that the restrictions were not reasonable and legal conditions attached to the use of a patented machine, for they restrained and permitted monopolization of commerce in articles not patented. A large part of the argument on both sides was devoted to a discussion of the effect of the Dick case, the defendants justifying their actions under that decision.

Mr. Justice McKenna, after pointing out that the agreements combined the manufacturers and jobbers in very much the same manner as manufacturers and jobbers had been combined in other combinations condemned by the court, continued:¹⁴

"The agreements clearly, therefore, transcended what was necessary to protect the use of the patent or the monopoly which

¹⁴226 U. S. at pp. 48, 49.

the law conferred upon it. They passed to the purpose and accomplished a restraint of trade condemned by the Sherman law.

* * * * *

"The added element of the patent in the case at bar cannot confer immunity from a like condemnation, for the reasons we have stated. * * * Rights conferred by patents are indeed very definite and extensive, but they do not give any more than other rights a universal license against positive prohibitions. The Sherman law is a limitation of rights which may be pushed to evil consequences and therefore restrained."

An important feature of this decision should be noticed. As the patents involved did not cover the ware which was the subject of the trade sought to be monopolized but related only to a tool used in the manufacture of the ware, the case might have been decided upon that distinction without any consideration of patent questions, but the court, in formulating a statement of the principles upon which the ruling was based, expressly refused to plant the decision on this narrow ground, but placed it upon the broad principle that rights conferred by patents, though extensive, do not give a universal license against positive prohibitions. This decision has become the leading case on the subject of the relation of the patent law and Sherman law to each other. It has been cited five times by the Supreme Court, and has influenced the decision of at least eighteen reported cases in the lower federal courts.¹⁵

¹⁵The decisions of the United States Supreme and Federal Courts which cite the case of the Standard Sanitary Mfg. Co. v. United States, *supra*, note 3, are the following: *Virtue v. Creamery Package Co.* *supra* note 6, 227 U. S. at p. 32; *United States v. Pac. & Arctic Co.* (1913) 228 U. S. 87, at p. 104, 33 Sup. Ct. 443; *Straus v. American Pub. Ass'n.* (1913) 231 U. S. 222, at p. 234, 34 Sup. Ct. 84; *Int. Harvester Co. v. Missouri* (1914) 234 U. S. 199, at p. 209, 34 Sup. Ct. 859; *Eastern Lumber Ass'n. v. United States* (1914) 234 U. S. 600, at p. 609, 34 Sup. Ct. 951; *Waltham Watch Co. v. Keene* (2 C. C. A. 1913) 202 Fed. 225, at p. 237; *United States v. New Departure Mfg. Co.* (D. C. 1913) 204 Fed. 107, at p. 113; *Ingersoll v. M'Coll* (D. C. 1913) 204 Fed. 147 at p. 149; *United States v. Patterson* (D. C. 1913) 205 Fed. 292 at p. 297; *United States v. Great Lakes Towing Co.* (D. C. 1913) 208 Fed. 733, at p. 774; *United States v. Int. Harvester Co.* (D. C. 1914) 214 Fed. 957 at p. 1000; *United States v. Great Lakes Towing Co.* (D. C. 1914) 217 Fed. 656, at p. 658; *Standard Sanitary Mfg. Co. v. Iron City Mfg. Co.* (D. C. 1915) 222 Fed. 671, at p. 672; *Patterson v. United States* (6 C. C. A. 1915) 222 Fed. 599, at p. 647; *United States v. United Shoe Machinery Co.* (D. C. 1915) 222 Fed. 349 at pp. 355, and 411; *United States v. Kellogg Corn Flakes Co.* (D. C. 1915) 222 Fed. 725, at p. 731; *Ford Motor Co. v. Union Motor Sales Co.* (D. C. 1914) 225 Fed. 373, at p. 383; *American Graphophone Co. v. Boston Store* (D. C. 1915) 225 Fed. 755, at p. 787; *United States v. Motion Picture Patents Co.* (D. C. 1915) 225 Fed. 800, at pp. 805, 807; *United States v. Eastman Kodak Co.* (D. C. 1915) 226 Fed. 62, at p. 78; *United States v. United Shoe Machinery Co.* *supra*, note 10, 234 Fed. at p. 150; *United States v. Corn Products Refining Co.* (D. C. 1916) 234 Fed. 964, at p. 1011; *Dowd v. United Mine Workers of America* (8 C. C. A. 1916) 235 Fed. 1, at p. 8.

The soundness of the decision in the Bathtub Trust case is made clear by an analysis of the nature of the right conferred by the patent franchise. As has often been stated, the right conferred by the patent laws is not the right to make, use and vend the thing patented, for this right exists by virtue of the common law and independently of the patent statutes; this right to make, use and sell the patented device is a natural right. The only right which the letters patent grant is the right to exclude all other persons from making, using, or vending the thing patented without the permission of the patentee.¹⁶

Before the Bathtub Trust decision the Supreme Court had decided that the right to sell a patented article is subject to the police regulations of the state. In *Patterson v. Kentucky*,¹⁷ it had sustained a statute of Kentucky which prohibited the sale of patented oil which the state inspector had condemned as unsafe for illuminating purposes. The defendant asserted a right to sell the oil by virtue of his letters patent, but Mr. Justice Harlan said:¹⁸

"We are of opinion that the right conferred upon the patentee and his assigns to use and vend the corporeal thing or article, brought into existence by the application of the patented discovery, must be exercised in subordination to the police regulations which the State established by the statute of 1874."

In *Webber v. Virginia*, Mr. Justice Field had said:¹⁹

"Congress never intended that the patent laws should displace the police powers of the State, meaning by that term these powers by which the health, good order, peace, and general welfare of the community are promoted. Whatever rights are secured to inventors must be enjoyed in subordination to this general authority of the State over all property within its limits."

In *Patterson v. Kentucky* and *Webber v. Virginia* the exercise of the police power of a state in prohibiting the sale of patented articles had been held not to be in conflict with the patent laws of Congress. The brief in the Bathtub Trust case, submitted by the writer of this article as Special Counsel for the United States, set forth the effect of those decisions as follows:²⁰ If the state

¹⁶Mr. Chief Justice Taney in *Bloomer v. McQuewan* (1853) 14 How. 539, at p. 548; *Patterson v. Kentucky* (1878) 97 U. S. 501, 506.

¹⁷*Supra*, note 16.

¹⁸97 U. S. at p. 505.

¹⁹(1880) 103 U. S. 344, 347.

²⁰See report of argument 226 U. S. at p. 33.

may prohibit altogether the sale of patented articles because of injury resulting from such sale to its citizens, it follows that the state may prohibit the sale of patented articles pursuant to combinations in restraint of intrastate trade and commerce, for such combinations are also harmful to the public. In the one case the state is *prohibiting* any sale, in the other case it is merely *regulating* the sale of the patented article in so far as it declares that no such sale shall be made under any unlawful combination monopolizing or restraining intrastate commerce. In either case the state is exercising its police power to protect its citizens; neither exercise of power conflicts with the patent laws. The reason is clear. The regulation of the state is being applied to natural rights and not to patent rights. The right to sell, a common-law right, is denied by the state in the one case and regulated in the other, the state acting in each case for the good of the public.

In passing the so-called anti-trust statutes Congress and a state legislative body act under different sources of power, but in each case the exercise of the power arrives at the same result, namely, prohibition of restraints of trade and of monopolies. The effect of the state act and of the Sherman act is the same; that is, the two acts relate to and operate upon the same subject matter, although one is enacted under the police power of the state and the other under the authority of Congress to regulate interstate commerce. If the exercise of the police power of the state does not encroach upon the domain of the patent laws, how can it be said that to include within the operation of the Sherman Act combinations restraining trade is to subtract from the monopoly of the patentee?

In May, 1913, the Supreme Court by a vote of five to four in the *Sanatogen* case²¹ applied to the sale and marketing of patented articles the ruling it had already made in the case of articles not protected by patents,²² and in the case of copyrighted books.²³

The defendant, a retailer, had purchased from wholesalers packages of *Sanatogen*, a patented article, and sold them to his retail trade at prices below those at which it was stated on the packages they should be sold, having knowledge of such notice. The notice read: "This size package of *Sanatogen* is licensed by us for sale and use at a price not less than one dollar (\$1.00)."

²¹*Supra*, note 4.

²²*Dr. Miles Medical Co. v. Park & Sons Co.* (1911) 220 U. S. 373, 31 Sup. Ct. 376.

²³*Bobbs-Merrill Co. v. Straus* (1908) 210 U. S. 339, 28 Sup. Ct. 722.

The patentee sued for infringement. Mr. Justice Day stated the question at issue to be:²⁴ "May a patentee by notice limit the price at which future retail sales of the patented article may be made, such article being in the hands of a retailer by purchase from a jobber who has paid to the agent of the patentee the full price asked for the article sold?"

The chief reliance of the plaintiff was the decision in the *Dick* case. Mr. Justice Day said:²⁵

"It is contended in argument that the notice in this case deals with the use of the invention, because the notice states that the package is licensed 'for sale and use at a price not less than one dollar', that a purchase is an acceptance of the conditions, and that all rights revert to the patentee in event of violation of the restriction."

Mr. Justice Day also said:²⁶

"it is a perversion of terms to call the transaction in any sense a license to use the invention. The jobber from whom the appellee purchased had previously bought, at a price which must be deemed to have been satisfactory, the packages of Sanatogen afterwards sold to the appellee. The patentee had no interest in the proceeds of the subsequent sales, no right to any royalty thereon or to participation in the profits thereof. The packages were sold with as full and complete title as any article could have when sold in the open market, excepting only the attempt to limit the sale or use when sold for not less than one dollar. In other words, the title transferred was full and complete with an attempt to reserve the right to fix the price at which subsequent sales could be made. There is no showing of a qualified sale for less than value for limited use with other articles only, as was shown in the *Dick* case. There was no transfer of a limited right to use this invention, and to call the sale a license to use is a mere play upon words."

The application of the "rule of reason" inevitably led to the conclusion stated by Mr. Justice Day. Referring to the statute granting exclusive rights and privileges to inventors and authors, he said:

"There is no grant of a privilege to keep up prices and prevent competition by notices restricting the price at which the articles may be resold."

²⁴229 U. S. at p. 11.

²⁵229 U. S. at p. 16.

²⁶229 U. S. at p. 16.

As stated above the Sanatogen case was decided by five to four, Chief Justice White, and Justices Day, Hughes, Lamar and Pitney constituting the majority, and Justices McKenna, Holmes, Lurton and Van Devanter, the minority. Three of the Justices who formed the majority, namely, Chief Justice White, and Justices Hughes and Lamar had been the dissenters in the Dick case. The accession of Justices Day and Pitney to their number in the Sanatogen case turned into a minority the four Justices who had been the majority in the other case. Three justices of the majority in the Sanatogen case, namely, Chief Justice White, and Justices Day and Pitney, and three of the minority, Justices McKenna, Holmes and Van Devanter are still on the bench. The other three, Justices McReynolds, Brandeis and Clarke have not taken part in any of the cases involving these questions. The change that has taken place in the composition of the Court is of special interest, in view of the important cases now pending.

The Shoe Machinery case, the fourth case decided,²⁷ was on a writ of error to a judgment sustaining a demurrer to the indictment. Three companies engaged in different lines of business and not competing, but making, according to the indictment, respectively, 60, 80, 70, and 80 per cent. of the lasting machines, welt-sewing machines, heeling machines, and metallic-fastening machines made in the United States organized in 1899 a new company to which they turned over their several businesses which, as has been stated, had not been competing businesses. The court held that the organization of a new company and the purchase by it of the stock and businesses of the three non-competing concerns did not constitute a violation of the Sherman act, but was simply an effort after greater efficiency. The opinion of the Court makes plain that if the three businesses had been competing businesses the conclusion of the Court would have been different.

As is commonly known some of the leases of the United Shoe Machinery Co. contain so-called tying or interlocking restrictions requiring the users of some of the company's machines to use certain others of its machines in the manufacture of shoes, but the lawfulness of these interlocking restrictions was not involved in the decision of the court. Mr. Justice Holmes said:²⁸

²⁷*Supra* note 5.

²⁸227 U. S. at pp. 216-217.

"It is to be observed that the conditions now inserted in the leases are not alleged to have been contemporaneous with the combination, or to have been contemplated when it was made. * * * Hence the only question before us is whether that combination taken by itself was within the penalties of the Sherman Act. *The validity of the leases or of a combination contemplating them can not be passed upon in this case.*"²⁹

THE PENDING CASES.

It remains to consider the four cases now in the Supreme Court.

The pending United Shoe Machinery case is one of the most complicated cases under the Sherman law, which has ever reached that Court. The criminal case, decided on a demurrer to an indictment, related to the legality of the consolidation of 1899. The pending case, an equity suit, involves the same question, and also the course of conduct of the Company since that date, particularly as evidenced by the use of the so-called "tying clause leases", and by the purchase of other companies, the legality of which was not considered in the earlier case. After a vast amount of testimony had been taken, the three judges of the lower court unanimously found for the defendants on all questions of fact and law. Their carefully considered opinions fill upwards of sixty-five closely printed pages of the Federal Reporter.³⁰

As the operations in making a shoe are said to be one hundred and fifty more or less,³¹ it is manifest that shoe machinery embodies many costly inventions and that its manufacture also requires great mechanical skill. In fact the shoe machinery business is one that necessarily has been built upon patents. Hundreds, possibly thousands, of patents are owned by the United Shoe Machinery Company. While many of the basic patents have expired, numerous patents on valuable improvements of complicated machines have long periods to run.

Although the Government's petition had alleged a restraint or monopoly of interstate commerce in "any and all kinds of shoe machinery", this position was later abandoned and it was conceded in the briefs and at the argument that the case related only to the following machines:³² 1. lasting machines used for attaching the upper to a last; 2. machines for fastening bottoms and heels to uppers; 3. machines for finishing bottoms and heels after

²⁹Italics are the authors.

³⁰United States v. United Shoe Machinery Co. (D. C. 1915) 222 Fed. 349.

³¹222 Fed. 349.

³²Opinion of Dodge, J., 222 Fed. at p. 364.

they have been so fastened; 4. eyeletting machines for inserting eyelets in uppers; 5. clicking machines for cutting out uppers. Of these five classes of machines Judge Dodge said:³³

"It is to be noted that such machines are insufficient for the making of a complete shoe and that no attempt to control machines for stitching uppers is charged."

The Shoe Machinery Company does not sell but leases its machines. It was conceded in the case that the leasing system as opposed to a system of selling was a proper method of distribution, and that it resulted in great advantages to shoe manufacturers.³⁴ Accordingly the marketing system employed by the Company involved a retention of title to the machines, all of which were covered by patents. The machines were leased under contracts which imposed limitations upon the use. Therefore, the question at issue is whether these limitations were reasonable and legal qualifications upon the use within the Dick case, or transcended what was necessary to protect the use of patents or the monopoly which the patent law conferred and "passed to the purpose and accomplished a restraint of trade condemned by the Sherman law", as defined by the rule suggested in the Bathtub Trust case.³⁵

The question also arises whether the leases were normal and reasonable contracts, entered into by the Shoe Machinery Company in the usual and natural development of its business, or were contracts like those condemned by the Supreme Court in the Anthracite Coal case,³⁶ where the Court held that the contracts under consideration were not the outgrowth of conditions peculiar to the Anthracite Coal region, but were the result of a concerted plan to thereby secure control of the sale of independent coal in the markets of other states, and thereby suppress competition.

Judge Putnam pointed out that, in view of the decision in the Bathtub Trust case, it can no longer be argued that combinations of patents are outside the Sherman Anti-Trust Act, although before that decision the Bement case³⁷ was thought to declare this view.³⁸

³³222 Fed. at p. 364.

³⁴Opinion of Brown, J., 222 Fed. at p. 401.

³⁵Standard Sanitary Mfg. Co. v. United States (1912) 226 U. S. 20, 48, 33 Sup. Ct. 9.

³⁶United States v. Reading Co. (1912) 226 U. S. 324, p. 357 *et seq.*, 33 Sup. Ct. 90.

³⁷Bement v. National Harrow Co. (1902) 186 U. S. 70, at pp. 90-91, 22 Sup. Ct. 747.

³⁸222 Fed. at pp. 354, 355.

The clauses of the leases to which much of the evidence was devoted were the so-called "exclusive use clause" and the "prohibitive clause". In the so-called "exclusive use clause" the lessees agreed that if they ceased to use exclusively machines leased from the United Company for doing work of the same kind upon shoes made by them, the lessor might at its option terminate all their leases of its machinery for doing work of that kind. The "prohibitive clause" provided that the leased machinery should not be used in the manufacture of shoes that had been or were to be operated upon by machines of certain specified kinds not leased from the lessor. In other words, the "exclusive clause" provided that all work of a certain kind should be done by machines leased from the Company, and the "prohibitive clause" prevented the use of leased machines upon shoes in the making of which the machines of other manufacturers were used.

In view of the large amount of attention and frequent criticism which have been directed to the "tying clauses", it is interesting to note that the following facts were established by the evidence in the case to the satisfaction of the lower Court: First, the customers of the Shoe Machinery Company were not compelled to take leases containing the "prohibitive clause". This was an alternative form of lease, in which the consideration paid by the customer was less than that demanded in the form of lease not containing the "prohibitive clause". Second, certain machines which have been described as the most important of defendant's machines and the center of its system,³⁹ namely, the Company's Goodyear welter and stitcher, were never put out on leases that prevented their use with machines of other kinds, obtained from other manufacturers.

Of these two clauses Judge Brown said, the other two Judges concurring:

"Both are limitations imposed by a patentee upon the use of his invention."⁴⁰

He also said:

"It is merely rhetorical to say that these contracts constitute an endless chain. We have seen that as to the prohibitive clause there is a mere question of price. As to the exclusive clause there is a mere question of choosing between two different sets of equipment for one operation."⁴¹

³⁹Opinion of Brown, J. 222 Fed. at p. 395.

⁴⁰222 Fed. at p. 399.

⁴¹222 Fed. at p. 400.

Judge Putnam said:

"There is no proof that the United Shoe Machinery Company has enforced its leases in any arbitrary or unreasonable manner.⁴²
* * * We find no evidence of what was shown especially in the Tobacco cases, namely, a purpose to destroy what could not be acquired by straightforward methods."⁴³

The so-called Motion Picture case,⁴⁴ the second Government case pending in the Supreme Court which involves the extent of the rights conferred by letters patent, was decided by the Court below in favor of the Government on the authority of the Bath-tub Trust decision.

This was a combination formed in the latter part of 1908 of practically all the manufacturers and importers of motion picture films at that time doing business in the United States. Sixteen patents owned by some of them were transferred to the Motion Picture Patents Company, a company which they formed, and thereupon each of the manufacturers and importers entered into a uniform license agreement with the Patents Company prescribing the manner in which the manufacturers should do business and distribute their product. A list was prepared of the exchanges and theatres with whom they would do business; to these also so-called licenses were issued; defendants enforced a rule that no manufacturer should distribute film to any exchange whose name did not appear on this list, and likewise that no exchange should supply films to any theatre not on the list; every theatre was restricted to displaying the pictures of the licensed manufacturers. A rule was adopted that no other manufacturer entering the field thereafter should be allowed to distribute his product to the exchangemen and the theatres so listed without the consent of the manufacturers forming the combination. No theatre, under penalty of instant cutting off of the necessary daily supplies of film, was allowed to display a picture not made by one of the manufacturers in the combination and distributed through an exchange on the list. No exchange under like penalty could distribute any films other than those made by the manufacturers. Under the guise of royalties, the manufacturers compelled the payment by the exhibitors or theatres of \$2. a week on all exhibiting machines, although many of these machines had been sold without condition

⁴²222 Fed. at p. 353.

⁴³222 Fed. at p. 357.

⁴⁴*United States v. Motion Picture Patents Co.* (D. C. 1915) 225 Fed. 800.

by the manufacturers to the exhibitors long before the combination was formed.

Having proceeded for eighteen months along the lines above indicated, the defendants formed their own distributing agency, the General Film Company, which within a few months became the sole distributing agency of the defendants. This was accomplished in part by the General Film Company buying 68 exchanges and in part by the manufacturers withholding supplies from other exchanges so that they were compelled to go out of business with the result that out of 116 exchanges handling the products of the manufacturers in 1909, only one exchange survived at the time the suit was brought in August, 1912.

All of the above restrictions were effected by means of so-called licensing agreements in which were incorporated, under the term "conditions of licensed use", the various restrictions described above and which, as the evidence established in the mind of the court, were vigorously enforced.

The defendants maintained that their commerce was outside the prohibitions of the Sherman act, the answer alleging it is "a lawful commerce in patents and patented articles, and is a commerce of such character that this respondent and all other defendants have a right to lawfully control and monopolize the same, and any part thereof, and thereby to lawfully exclude all others therefrom."⁴⁵ It was substantially admitted that with the patent right ownership out of the case, the United States should have the relief prayed.

Judge Dickinson held that the scheme of the combination "had no normal and real relation to the assertion and protection of patent rights", and that the restraint imposed upon the trade "was not merely incidental to protect the rights granted by the patents". He said:⁴⁶

"The legal justification, set up by the defendants, for what they have done, and for everything they have done, is that in so doing they were lawfully asserting rights acquired by them through a large number of overlapping patents. The total number reaches sixteen. Ten of these are admittedly, however, of minor importance, and, indeed, of no importance, in their bearing upon the case. The remaining six may be roughly catalogued as one each pertaining to films, cameras, and what is termed the "Latham loop", and three to projecting machines. The ownership of these patents was

⁴⁵Ans. Pat. Co. fol. 299.

⁴⁶225 Fed. at p. 810.

divided among some of the defendants. Others had no interest therein, except in so far as they dealt in the different apparatus, features of which were covered, or claimed to be covered, by the several patents, respectively. If the combination had been limited, and the agreements and the scheme in its entirety had possessed, or could be found to have, any normal real relation to the assertion and protection of these patented rights, and this had been the end proposed, the defendants would be upheld in the maintenance of such rights.

"We are constrained, however, to find that there was no such relation, but that the end, directly proposed, was the imposition upon the trade of an undue and unreasonable restraint, in order that, as the immediate and direct effect and result of the combination, the defendants might monopolize the trade in all the accessories of the motion picture art so far as they are articles of commerce. A further end proposed, and which has largely been achieved, is the domination of the motion picture business itself, and it requires no prophetic vision to foresee that the ultimate result would be that no play would be written, or dramatically enacted, except by authors and artists favored by the defendants."

Judge Dickinson also held that the undue and unreasonable restraint imposed upon the trade

"was not merely incidental to efforts to protect the rights granted by the patents, but went far beyond the fair and normal possible scope of any efforts to protect such rights.

* * * * *

"The end and purpose of the combination, and in this sense the motive or moving cause, further was not to protect the patent rights, which the Motion Picture Patents Company was organized to take over; but the control of the patents was made a feature of the scheme, in the belief, or at least the hope, that this would render the scheme (otherwise illegal) not open to the condemnation of the law."⁴⁷

The Motion Picture industry today is the result of all the wonderful discoveries and advances that have taken place in the art of photography during the last three score years. As pointed out in the brief in the case submitted by the writer of this article as Special Counsel for the United States, many inventions made in that period have become the property of the public by reason of the expiration of the patents thereon. The sixteen patents owned by the Patents Company, of which ten, as found by the Court, have no value, clearly did not entitle it to monopolize the industry under claim of patent right. This decision demonstrates the soundness of

⁴⁷225 Fed. at p. 811.

the "rule of reason", which prohibits every combination, no matter the form, which has brought about the evils against which the Sherman act is designed to protect the people. If the owners of a few patents in any line of industry may combine and control the business by means of such so-called license restrictions as were incorporated in the license agreements in the Patents Company case, the Sherman act would mean nothing. A few patentees by combining a few inventions could deprive other inventors of the use of their inventions in the same art by excluding them from the industry, and by their combination they could also deprive the public of the rights acquired in inventions respecting which the patents have expired.

The three Judges who decided the Shoe Machinery case, applied the rule that was applied by the Philadelphia Judge in the Motion Picture Trust case, but held on the evidence and the issues before them that no combination within the "rule of reason" had been established. It is manifest that it was the difference in the character of the evidence adduced in the two cases which led to opposite results.

The acts of the companies associated in the Motion Picture Trust and the effect upon competition were inquired into by the Judiciary Committee of the Senate which had under consideration the proposed Clayton act and were mentioned in the report of Judge Clayton, Chairman of the Judiciary Committee.⁴⁸

If the Supreme Court affirms the decision of the Circuit Court of Appeals for the Second Circuit in the Victor Talking Machine Company case,⁴⁹ there will be very little left of the Sanatogen decision, for the only apparent difference between the two cases is that in the Victor case the word "sale" was omitted from a notice and license agreement similar to the notice and license agreement used in the Sanatogen case.⁵⁰ This elimination of the word "sale" was evidently for the purpose of reserving title. The Circuit Court of Appeals under the authority of the Dick case

⁴⁸See "The Law of the Motion Picture Industry," pp. 10-11, an instructive lecture (privately printed) delivered by Mr. Gustavus A. Rogers at the College of the City of New York in November 1916, and Vol. 1 pp. 470-502, Hearings before the subcommittees of the Committee of the Judiciary, Sixty First and Sixty Second Congress.

See also Vol. 2, p. 1964 of the Report of Hearings before Judiciary Committee, Sixty Third Congress, Second Session.

⁴⁹Victor Talking Machine Co. v. Strauss (2 C. C. A. 1916) 230 Fed. 449.

⁵⁰*Supra*, p. 215.

reversed a decree of District Judge Hough,⁵¹ who, on the authority of the Sanatogen case had dismissed the complaint in a suit for infringement.

As pointed out above the Dick decision, so far as appears in the case, related only to one license contract; it did not concern a wholesale or retail method of marketing products in commerce, whereas the Sanatogen case applied to a system for controlling the retail prices on patented articles.

The Victor Company has a system of licensed distributors or wholesalers and licensed dealers, the latter numbering over seven thousand and dealing directly with the "ultimate user", that is, the public. Pursuant to written license agreements the Company distributes its machines and records to licensed distributors who acquire only the right to use the machines for demonstrating purposes, and also the right to assign the right to use to the dealer. The latter has the right to use only for demonstrating purposes and also to assign the right to use to the "ultimate user", a member of the public. Schedules of prices are established by the Victor Company applicable to the different stages of distribution, that is governing wholesalers and retailers. The important restrictions contained in the license agreement are repeated on a label attached to each machine and are stamped on an envelope containing each record by means of which the "ultimate user" receives actual notice of the restrictions upon the title and the use of the machine. The "ultimate users" acquire the right to use the machines, but have no right to assign or transfer that use under any circumstances until the expiration of the youngest patents when, without any further payment of any kind the absolute ownership in the instrument and the record vests in them. In the meantime the title purports to remain with the Victor Company, which, however, can regain possession of the instrument only after breach of one of the conditions and upon repayment of the royalty paid by the user, less 5% per annum of the full royalty for each year that it shall have been used.

It should be noted that the Victor Company first parts with its possession of the instruments and records to the distributor who pays for the goods delivered to him and no further or additional payment is thereafter required of the distributor by the Victor Company, and that the distributor parts with possession to the licensed dealer and no further or additional payment is re-

⁵¹230 Fed. at p. 450.

quired of the dealer by the distributor or by the Victor Company.

The machine can only be used for sound records, with sound boxes and needles manufactured by the plaintiff, but there was in the case no charge of any infringement because of a use of the machines with other than the records and needles stipulated in the license.

All instruments and records manufactured since August 1, 1913, have been marketed under this system.⁵²

The complaint charged that the defendants, the members of the firm of R. H. Macy & Company, having no contractual relations with the plaintiff, or with any of its licensed distributors or licensed dealers, had procured some records and machines at less than the list price stated on the label attached to each machine, and with full knowledge of the license agreements; complainant claimed the right, by virtue of the patent laws, to restrain the defendants from any transfer of the instruments and records solely for the reason that they had not been designated as licensed dealers. On a motion to dismiss the complaint the District Court held that the facts disclosed either *a sale of the right to use* the instrument or *a sale of the instrument* by the Victor Company, and that the Company could not control the resale of the right to use the instrument or the resale of the instrument itself. The Circuit Court of Appeals reversed this decision.

In the Sanatogen case Mr. Justice Day had said: "It is a perversion of terms to call a transaction in any sense a license to use the invention" and also "to call the sale a license to use is a mere play upon words"; the court laid down the broad principle that in the patent laws there is no grant of a privilege to keep up prices and prevent competition by notices respecting the price at which the articles may be sold. This principle of the Sanatogen decision seems to control the ultimate decision in the Victor case. The decision of the Supreme Court in *Dr. Miles Medical Company v. Park & Sons Company*,⁵³ is also pertinent. There the Supreme Court pronounced unlawful a scheme of so-called agency contracts under which a manufacturer attempted to establish uniform prices on all sales by wholesalers and retailers of proprietary medicines manufactured by him. The fact that the scheme had been given the form of agency contracts, and title thereby retained, did not affect the result; the Court looked behind the form of the trans-

⁵²The Sanatogen case was decided about two months earlier, on May 26th 1913.

⁵³(1911) 220 U. S. 373, 31 Sup. Ct. 376.

action. So here, notwithstanding the use of the term "license to use", the manufacturer has in fact parted with all interest in his product, and it would seem that the only purpose of the licensing arrangement was to control prices in the manner forbidden by the Sanatogen decision.

The last case to be considered is that of the *Motion Picture Patents Company v. Universal Film Manufacturing Company, Universal Film Exchange and Prague Amusement Company*,⁵⁴ in which the Circuit Court of Appeals, Second Circuit, held the Sanatogen case to be controlling, and refused to extend the doctrine of the Dick case. The difference between this case and the Victor case is that in the latter the claim of the Victor Company is that title to the machine did not pass, but there was granted to the purchaser only a right to use, while in the present case there was admittedly a complete transfer of title. The case involves a license restriction incorporated in one of the license agreements entered into by the plaintiff, the Motion Picture Patents Company, about the time the combination involved in the Government case was formed, and which were held by the Court in the latter case to be among the means adopted to carry into effect the object of the combination.

The plaintiff licensed the Precision Machine Company (not a party to the suit) to manufacture and sell motion picture exhibiting machines embodying certain inventions, including the patent in suit, in consideration of royalties and other covenants contained in the agreement. One of the covenants was that the licensed exhibiting machine should be sold by the licensee, the Precision Company, under the restriction that it be used solely for exhibiting such motion pictures, containing the inventions of Reissued Letters Patent 12,192, as were leased by a licensee of the Patents Company and upon other terms to be fixed by the latter company. The agreement also provided that the Machine Company should attach to each machine manufactured and sold pursuant to its license a plate containing the following notice:

"The sale and purchase of this machine gives only the right to use it solely with moving pictures containing the invention of Reissued Patent No. 12,192, leased by a licensee of the Motion Picture Patents Company, the owner of the above patents and Reissued patent, while it owns said patents, and upon other terms to be fixed by the Motion Picture Patents Company and complied with by the user while it is in use and while the Motion Picture Patents Company owns said patents."

⁵⁴(2 C. C. A. 1916) 235 Fed. 398.

It is important to note that patent 12,192, which related to the motion picture film, expired in August, 1914, several years after the execution of the license agreement and before the alleged act of infringement. Accordingly, at the time of the alleged contributory infringement the film was unpatented and open to the public to make, sell and use.

The Precision Company manufactured a motion picture machine under its license and sold it to another company, which company in November, 1914, after the expiration of the film patent leased it to one of the defendants, the Prague Amusement Company. In 1915, the defendant Universal Film Manufacturing Company made two pictures which were distributed through another defendant, the Universal Film Exchange to the defendant Prague Amusement Company, and exhibited by the latter in its theatre by means of the exhibiting machine. The film so used had not been made by a licensee of the Patents Company, as the Universal Film Company was not licensed by that Company, that is to say it was not one of the manufacturers which had formed the combination described in the Government case and which had devised the licensing arrangement.

It appeared that the plaintiff had obtained a substantial royalty from the sale of the exhibiting machine and also that it was the object of the petitioner in requiring its licensees to place the notice in question on the patented machine to levy tribute on the film used on such machines after the patent on the film had expired, which tribute was to be in addition to a substantial profit on the patent rights in the machines themselves. The defendants maintained that to restrict the use of the machine to film licensed under an expired patent was an attempt to unlawfully continue the term of that patent and the statutory monopoly thereby granted. Furthermore, they contended that the notice as to "terms to be fixed" was too vague and indefinite to be enforceable and was not a reasonable and legal qualification upon the use of the machine.

Judge Hough directed that the complaint be dismissed on the ground that "the limitation on the use of a patented article sold in the manner above set forth is invalid". He held that the notice was "specifically bad in that it attempts not only to confine the use of a machine once sold and delivered to a particular kind of film, but further seeks to render that use subject to any and every restriction or regulation which the patent owner may from time to time choose to make or vary". The Circuit Court of Appeals

affirming the decree of Judge Hough held that the case came within the Sanatogen decision rather than the Dick case, and also that the Clayton act applied.

A reversal by the Supreme Court of this decision would be most far reaching in its effect. Ninety-nine per cent. of the commerce relating to the motion picture industry is in the positive films, which are unpatented. The "Latham Loop" patent covers but a part of the exhibiting machine, a complicated machine, which is the result of many inventions. If the Court should hold that the owner of the Latham patent, covering but a part of a machine embodying many inventions, may dictate what films may be used on the machine, it would vest in him a complete monopoly in an article not patented, which monopoly would be acquired, not because of the ownership of a patent on the article, but by reason of the ownership of a patent on something else. Thereafter the monopoly conferred by letters patent would not expire with the termination of the period covered by the letters patent, for it could be continued indefinitely by means of license agreements relating to the use of other articles covered by patents. Such a decision would make possible the creation of a monopoly in unpatented things. The facts are not the same as in the Dick case for the reason that positive films can be used only on exhibiting machines whereas the use of paper and ink is not limited to a Mimeograph machine.

EDWIN P. GROSVENOR.

NEW YORK CITY.